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By Electronic Filing

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th St., SW
Washington, D.C. 20554

Re: CC Docket Nos. 93-193; 94-65 and 94-157

Dear Ms. Dortch:

I write on behalf of AT&T Corp. ("AT&T") in response to recent *ex parte* attempts by Verizon and SBC to defend unlawful 1996 "exogenous cost" rate hikes that they and the other Bells based on retroactive restatements of their 1992-1995 rate bases. The rate base restatements reversed the Bells' deduction from rate bases in those prior years of the amounts recorded on their books as "other postretirement benefits" ("OPEB") liabilities. OPEB obligations are amounts that the Bells expect to pay in *future* years to retirees (in the form of medical, dental and other benefits). OPEBs became an issue when the Commission required the Bells to begin reflecting future OPEB obligations as liabilities on their regulatory accounting books as of January 1, 1993. Applying longstanding Commission policy (and basic economic principles) that rates should not provide a return on such zero-cost sources of funds – Verizon and SBC have the free use of the money they show as OPEB "liabilities" on their books for years before they actually pay anything out to the retirees – the Common Carrier Bureau gave the Bells immediate and express direction that they were to deduct these amounts from their rate bases (as they had long been required to do for indistinguishable postretirement pension benefits). *See Uniform Accounting for Postretirement Benefits Other Than Pensions in Part 32*, 7 FCC Rcd. 2872 (1992) ("*RAO 20 Letter*"). The Bells did so each year from 1992 to 1995.

In 1996, the Commission ruled that the Bureau had acted beyond the scope of its delegated authority in issuing the *RAO 20 Letter*. *See* Memorandum Opinion and Notice of Proposed Rulemaking, *Responsible Accounting Officer Letter 20, Uniform Accounting for Post Retirement Benefits Other Than Pensions in Part 32*, 11 FCC Rcd. 2957, ¶ 19 (1996) ("*1996*

Suspension Order"). The Commission did not question the substantive correctness of the Bureau's decision. To the contrary, in the same order that rescinded the *RAO 20 Letter* on that purely procedural ground, the Commission initiated a proceeding to memorialize the substance of the *RAO 20 Letter* in a formal Commission rule, *id*. ¶ 29; nine months later the Commission did just that. *See Report and Order, Responsible Accounting Officer Letter 20, Uniform Accounting for Postretirement Benefits Other Than Pensions, Amendments to Part 65, Interstate Rate of Return Prescription Procedures and Methodologies, Subpart G, Rate Base*, 12 FCC Rcd. 2321 (1997) ("*OPEB Rate Base Order*"). Despite the Commission's clear and consistent statements and policies in this area, the Bells seized upon the few month period between recission of the *RAO 20 Letter* and the formal adoption of the new rule as an opportunity to appropriate windfalls from ratepayers.

The Bells hatched an ingenious plan. Returns are determined by reference to rate bases, and, under the price cap rules then in effect, excess returns generated "sharing" obligations to reduce rates, because excess returns meant that the price caps were set too high and that ratepayers were being charged unjust and unreasonable rates. Because the Bells were then – as they are today – earning exorbitant returns, they had sharing obligations in each year from 1992 to 1995. The Bells viewed their window of opportunism as follows: if we treat the recission of *RAO 20 Letter* as authorizing us retroactively to reverse our OPEB rate base deductions for each year from 1992 to 1995, that will make our rate bases look bigger; if our rate bases look bigger and we retroactively recalculate our returns, our returns will look smaller (because the rate base is the denominator in the return calculation); if our returns look smaller and we retroactively recalculate our sharing obligations, we can claim that we shared too much with ratepayers in all of those prior years; and, if we shared too much in *those* years, then, by golly, we ought to be able to raise our rates *this* year by the sum total of all of that past year "oversharing." The Bells implemented their plan in the 1996 price cap tariffs under investigation in this proceeding. No one was fooled by this, and the Commission immediately suspended the tariffs and set them for investigation, finding that the Bells' tariffs raised "a substantial question of lawfulness." *1996 Suspension Order* ¶ 4.

There has never been any dispute in this proceeding that allowing the Bells to keep the rate hikes they collected in the 1996-97 tariff year would be to grant them a pure windfall at the expense of ratepayers. The Commission has already ruled that the Bells' rate base practice is unjust and unreasonable and would allow them to overrecover by forcing ratepayers to pay returns on assets funded with zero-cost funds. Rather, the fight here is over the Bells' claims that the Commission is powerless, as a legal matter, to stop them from exploiting rule gaps that they claim bar the Commission from reaching the undeniably correct result in this tariff investigation. The Bells obviously bear a heavy burden to demonstrate that the Commission is without authority to do what the public interest so clearly demands. They have not remotely met that burden.

The Bells contend that this dispute can be resolved by a straightforward application of Commission rules in place in 1996. AT&T agrees. The price cap rules in place in 1996 expressly and absolutely foreclose the rate hikes at issue here. The Bells' contrary claim reflects their improper focus on the wrong issue and the wrong rules. The Bells focus on whether the Commission's 1996 rate base rules allowed them to get away with restating their 1992, 1993, 1994 and 1995 rate bases (in direct contravention of the Commission's longstanding policy with regard to zero-cost sources of funds). The Part 65 rate base rules at the time of these tariff filings stated that "[t]he rate base shall consist of the interstate portion of the accounts listed in Sec. 65.820 that has been invested in plant used and useful in the efficient provision of interstate telecommunications services regulated by this Commission, minus any deducted items computed in accordance with Sec. 65.830." 47 C.F.R. § 65.800. Because 47 C.F.R. § 65.830 did not, at that time, specifically address OPEBs – which is not surprising, given that the OPEB liabilities *did not even exist* when the rate base rules were promulgated – the Bells claim that the Commission has no choice but to allow them to restate their rate bases for each year from 1992-95.

So what. Assuming, *arguendo,* that the Bells could lawfully have restated their rate base back to 1992, or even to 1962 – and that the Commission was powerless to deem that practice unjust and unreasonable in violation of 47 U.S.C. § 201 in the absence of a Commission rule expressly addressing the issue – it does not at all follow that it was lawful for them to use those changes to implement massive exogenous cost increases to their price cap indices ("PCIs") and rates, as they did in the 1996 tariff filings at issue here. Their ability to do the latter is governed by the *Part 61 price cap rules*, not the Part 65 rate base rules. And the Part 61 price cap rules expressly and absolutely foreclose the challenged exogenous cost increases at issue here.

The price cap rules allow for periodic adjustments to price caps, but *only* as expressly authorized by the formula contained in those rules. Rate changes based upon "exogenous" cost changes, in particular, are strictly limited, reflecting that the very purpose of price cap regulation is to remove the linkage between costs and rates to provide better incentives for efficient operation. Thus, under the rules in effect in 1996 (and today), "[e]xogenous changes represented by the term 'delta Z' in the [current period PCI] formula . . . *shall* be limited to those cost changes that the Commission shall permit or require by rule, rule waiver or declaratory ruling." 47 C.F.R. § 61.45(d). Because the Bells do not dispute that they never sought (much less obtained) a rule waiver or declaratory ruling permitting them to implement the disputed rate base-restatement generated exogenous cost increases to their 1996 PCIs, the Bells must, to succeed here, identify a pre-existing Commission rule that expressly authorized those exogenous cost increases. There is no such rule.

The Bells point to 47 C.F.R. § 61.45(d), which, as one component to the "delta Z" exogenous cost factor in the PCI formula, requires the Bells to "make such temporary exogenous cost changes as may be necessary to *reduce* PCIs to give full effect to any sharing of *base period* earnings required by the sharing mechanism." *See* 47 C.F.R. § 61.45(d) (emphasis added). The "base period" is the "12 month period ending six months prior to the effective date of annual price cap tariffs." 47 C.F.R. § 61.3(e). The effective date of the Bell's 1996 tariffs was July 1996, which means that the relevant "base period" was 1995. Accordingly, under the Bells' own "sharing theory," they could, *at most*, invoke § 61.45(d) as a justification for reflecting reversal of the OPEB deduction for the 1995 base period rate base that is used in the exogenous cost sharing adjustment authorized by that rule, and possibly to reflect the restatement of 1994 sharing obligations based upon "final" rate base figures.

With respect to 1992 and 1993, the Bells quite plainly are seeking an extraordinary exogenous cost increase to their 1996 PCIs and rates that is neither permitted, nor required, by any Commission rule. The Bells therefore were required to seek a rule waiver or a declaratory ruling authorizing such a change. As noted, they did not do so. Accordingly, a straightforward application of the version of 47 C.F.R. § 61.45(d) in effect at the time of the tariff filings unquestionably forecloses the Bells' proposed exogenous cost increases to their 1996 PCIs and rates to reflect retroactive restatement of rate bases, returns and sharing obligations for the 1992-1993 tariff years.

But there is a second independent commission rule that categorically prohibits the Bells from increasing their 1996 PCIs to account *even for the 1994 and 1995 rate base restatement-related sharing adjustments*. About a year before the Bells sought to inflate the 1996 PCIs with unfunded OPEB-related costs, the Commission expressly "limit[ed] exogenous cost treatment of cost changes resulting from changes in the USOA requirements to *economic cost changes*." First Report and Order, *Price Cap Performance Review for Local Exchange Carriers,* 10 FCC Rcd. 8961, ¶ 292 (1995) ("*1995 Price Cap Order*"). The Commission unambiguously ruled that "when an accounting change *that otherwise meets the existing standards for exogenous treatment* also affects cash flow, carriers will be able to raise PCIs to recognize this effect," but "[w]ithout a cash flow impact, carriers will *not* be able to raise PCIs to recognize an accounting change." *Id.* ¶¶ 292, 294 (emphasis added). Thus, at the time of the tariff filings at issue here, an ILEC was required to make two independent showings to justify any exogenous cost increase to PCIs: (1) that the increase was authorized by rule, rule waiver or declaratory order, and (2) that even if the increase "otherwise meets" that standard, that it also has a cash flow impact. And the Commission had already determined in the same 1995 order that unfunded OPEB amounts are exactly the type of accounting changes that have *no* economic cost or cash flow impact. *Id.* ¶ 307. The "cash flow impact" rule is categorical and fatal to the Bells' tariff filings.

In short, if the Commission is to heed Verizon's battle cry in this proceeding that "the Commission must follow its own rules,"[1] it must reject the Bells' claims and order long delayed refunds to ratepayers. That is why the Bells' real agenda is to convince the Commission

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[1] *Reply Comments of Verizon* at 1-2; *see also* SBC Feb. 27 *Ex parte* at 1.

to let them off the hook *notwithstanding* Commission rules that foreclose these rate hikes. In this regard, Verizon argues that the Commission should exercise "discretion" to put the Bells in the same position they would have occupied but for the Bureau's procedural error in issuing the *RAO 20 Letter*. The Bells refer the Commission to cases where rates adopted by regulatory agencies were found to be unlawful by reviewing courts, and where the agencies were permitted to exercise discretion to correct the legal error by permitting the utility retroactively to recover the difference between the unlawful rates and newly-determined lawful rates. *See, e.g.,* Verizon Direct Case Reply at 15 (*citing United Gas Improvement Co* v. *Callery Properties*, 382 U.S. 223 (1965); *Public Utilities Commission of California* v. *Federal Energy Regulatory Commission*, 988 F.2d 154 (D.C. Cir. 1993); *Natural Gas Clearinghouse* v. *Federal Energy Regulatory Commission*, 965 F.2d 1066 (D.C. Cir. 1992)). But, as the cited decisions make clear, an agency's discretion to permit retroactive rate changes is grounded in a court ruling that prior rates adopted by the agency were, in fact, held to unlawfully low levels – the error correction doctrine is designed to serve equitable interests when substantive legal errors have been made.[2] The Bells plainly have no such equitable interest here. They seek pure windfalls. And the "error" that they rely upon here is not a substantive legal error at all, but simply a procedural error – the wrong Commission entity issued the plainly lawful ruling that OPEBs like other zero cost funds, must be deducted from the rate base. Because there is no basis to conclude that the Bells' rates in 1992-1994 were unlawfully low – and certainly no court decision so finding – the Commission must reject Verizon's request that it simply ignore the rules in effect at the time of the tariff filings.

In all events, requiring refunds *would* put the Bells in the same position they would have occupied but for issuance of the *RAO 20 Letter*. The Commission has consistently stated that it "agreed with the Bureau" on the substance of the *RAO 20 Letter*. *See, e.g., OPEB Rate Base Order* ¶¶ 17-19; *1996 Suspension Order* ¶ 25. Thus, if the legal error complained of had not been made – *i.e.*, issuance of the *RAO 20 Letter* by the Bureau, rather than the full Commission – there would have been a binding *Commission* order in place during the 1992-1995 period requiring deduction of OPEB liabilities from rate bases. Indeed, even in the best case scenario for the Bells – no RAO 20 ruling by the Bureau *or* the Commission in 1992 – this issue would have been resolved in the very first year that the Bells attempted to base sharing on rate bases without OPEB deductions. Because the Bells have never had any serious argument on the merits why OPEBs should not, like other zero-cost funds, be deducted from the rate base, the Commission would have suspended the Bells' tariffs (as it, in fact, did the first time they tried to

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[2] Each of the cases relied on by Verizon addressed substantive legal errors. *See United Gas Improvement Co* v. *Callery Properties*, 382 U.S. 223, 225-26 (1965) (rates violated the Natural gas act); *Public Utilities Commission of California* v. *Federal Energy Regulatory Commission*, 988 F.2d 154, 163 (D.C. Cir. 1993) (rates were "arbitrary and capricious" and "prejudicial"); *Natural Gas Clearinghouse* v. *Federal Energy Regulatory Commission*, 965 F.2d 1066, 1073 (D.C. Cir. 1992) (rates were arbitrary and capricious). Verizon cites no case that approved, much less required, rate changes where, as here, the agency's error was purely procedural.

implement their rate-inflating scheme) and expeditiously issued an order and a rule that precludes LECs from including such zero-cost unfunded OPEB amounts in the rate-base (as it, in fact, did in nine months from NPRM to rule). Even under the Bells' erroneous view that such a rule, even if promulgated in the tariff investigation itself, could operate only prospectively, that means that in the "but for" world that the Bells posit, they could, at most, have gotten away with their scheme for the first year (1992). Thus, rejecting the Bells' arguments and requiring refunds puts them – and, more importantly the ratepayers that *do* have legitimate equitable interests here – in the same position that would have been in but for the Bureau's procedural error.

Respectfully submitted,

/s/ David L. Lawson

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